BearBull Global Investments Group

Economic Research

WEEKLY ANALYSIS

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A stronger euro will bolster GDP growth in Switzerland

Real GDP up +0.3% in Q2. The SECO and the SNB revise their growth forecasts downward. Nevertheless, the likelihood of an upturn is enhanced by the appreciation of the euro.

Key points

- Real GDP up +0.3% in Q2
- A stronger euro promises further GDP growth
- Final demand bolsters GDP growth
- The trade balance is not yet benefitting from the weaker franc or the European recovery
- Green light for public and private consumption
- Increasingly positive leading indicators for the manufacturing and industrial sectors
- The appreciation of the euro has not yet significantly affected the SNB's actions
- Our 15 January 2015 post-choc forecast predicting an exchange rate of 1.20 against the euro is materialising
- Impending rise of long-term interest rates and inflation in our country

Real GDP growth up +0.3% in Q2

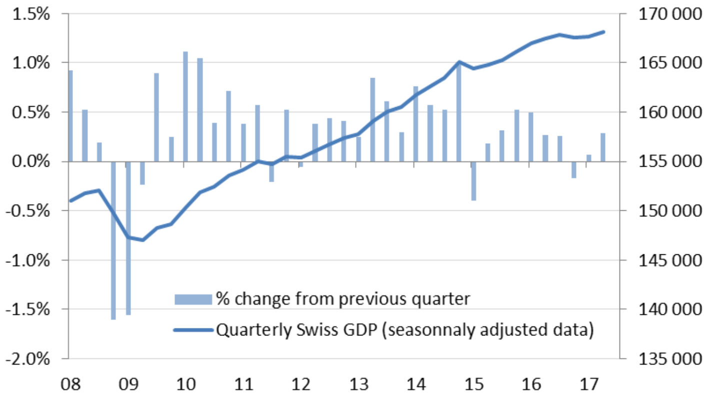
The latest growth figures released by the Swiss State Secretariat for Economic Affairs (SECO) show real GDP growth of +0.3% in Q2. Q1 growth was revised down from +0.3% to +0.1%, however, reviving worries regarding the quality of the recovery in our country.

The revision of Q1 results also caused adjustments to FY2017 growth forecasts. The SECO thus reduced its economic growth forecast for the current year for the third time, revising it downward to +0.9%. The SNB, scarcely more optimistic, reduced its growth forecast for the same period down from +1.5% to +1%.

The forecast of the KOF Swiss Economic Institute (+1.3%), slightly more optimistic in spite of similar adjustments, is not unfounded in our view, in particular given developments in the currency markets.

We believe that, while the downward revision of Q1 results obviously affects the FY outlook, the Swiss economy should nevertheless experience growth in excess of 1% in FY2017 given that a significant acceleration in Q2 is increasingly likely.

Swiss economic performance (GDP in M CHF)



Sources: SECO, BBGI Group SA

The weakness of the franc against the euro, witnessed with relief by numerous economic actors over the summer, will very likely have a positive impact on economic outcomes in Switzerland over the next several quarters.

At its current exchange rate of 1.16 (at time of writing), the euro has already regained over 75% of the losses it suffered on 15 January 2015. Let us also note that the forecast we published on 15 January 2015 and have since reiterated on several occasions is materialising, namely, that the franc would weaken and return to a level of 1.20 thanks to the SNB's negative interest rate policy.

For 2018, GDP growth forecasts remain somewhat more optimistic, predicting potential growth of +2%, mainly due to the improvement in the global economic outlook expected over the next several quarters as well as to a stronger boost from the domestic economy and an upswing in exports.

Final demand still clearly sustaining GDP growth

1H2017 still turned out positively for our economy, in particular due to the economic upturn in the Eurozone and among Switzerland's main trading partners more generally. In Q2, private consumption improved slightly (+0.2%), with public spending also delivering a moderately positive contribution (+0.3%). We note a clear slowdown in investment spending on capital goods, which is up only +0.3% after rising +1.7% in the previous quarter. In contrast, construction is on the rebound, growing +0.7% after posting a +0.4% rise in the prior quarter. Manufacturing progresses by +0.9%, exhibiting unexpected vigour.

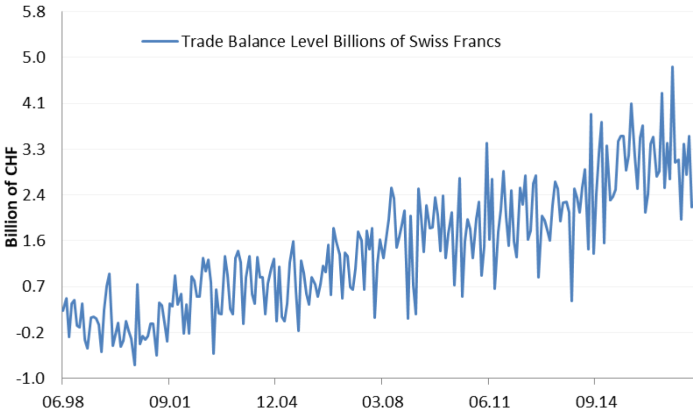
On the other hand, the contribution of the trade balance in goods and services was rather negative. Merchandise exports inched up +0.5%, while service exports declined by -0.3%. Merchandise imports posted a large increase (+5.5%) driven by the growth in the demand for chemical and pharmaceutical products. Service imports also increased (+1.7%), in particular with regard to telecommunication and IT services.

The trade balance is not yet benefitting from the weaker franc or the European recovery

Switzerland's trade balance reached a peak in January, attaining its highest level ever at over 4.77 billion francs. Since then, a rising euro and stronger economic momentum in the Eurozone have prevented it from reaching new heights. The trade balance has thus trended downward over the past eight months on a relative basis, although this year's average trade surplus is in fact identical to 2016's (3.07 billion/month). At the beginning of the year, we had pointed to the excellent level of the trade balance in January, prompting hope for 2017. This seems to be materialising, along with a real possibility of seeing our foreign trade finally benefit from a stronger European economy and the weakness of the franc against the euro.

Any improvement in foreign trade will require a sharper upturn in exports in 2017 in order to provide a truly positive and lasting contribution to GDP growth. In August, exports did grow +6.1% in real terms, reaching 16.3 billion francs, thanks to the machines and electronics sectors, which improved markedly (+10.8%). A +6.5% increase in imports to 14.2 billion is preventing a more satisfactory overall outcome for now.

Trade balance



Sources: Bloomberg, BBGI Group SA

The most significant export sectors are contributing to these developments.

The machines sector along with the textiles, vehicle and watch segments all contributed positively. The watch sector confirms its recovery for the fourth consecutive month, posting yoy growth of +4.2% in August thanks to rising demand in China and Hong Kong. Year-to-date results are once again positive, even if the +1.2% increase in exports is still far from previous years' records.

The improvement in the global outlook will also be favourable to our economy and exports.

Lights switching to green with regard to consumption

Domestic consumption continued to support GDP growth in Q2 without, however, showing signs of a stronger recovery, nevertheless still anticipated. Indeed, domestic demand is showing no signs of accelerating, in spite of positive economic conditions both in our country and the neighbouring countries. Consumption climate indicators have improved slightly, however, as suggested by both the UBS index, which is showing a clear uptick in confidence levels over the past three months, and the CS index, which is stabilising at its highest levels in the past ten years. In this context, retail sales are indeed stronger than in 2015 and 2016 though struggling to establish a clear upward trend.

However, the Swiss have little to worry about and should not curtail their consumption. Certainly, along with the improvement in the international outlook, the job market in Switzerland has been showing signs of an upturn since the beginning of the year. The unemployment rate has indeed returned to low levels (3%) and is approaching its all-time record of +2.5% in 2008.

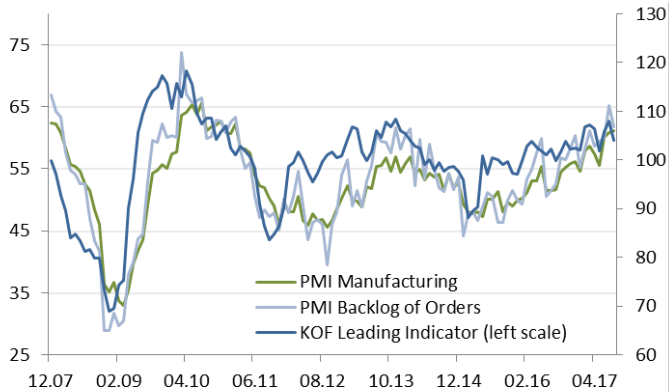
The improvement in the outlook for global growth should also have an increasingly clear and positive impact on the economic climate in Switzerland over the next several months. Private consumption should thus remain on a positive trend, bolstering GDP.

Public consumption spending will remain volatile in 2017, but the federal and cantonal governments' finances are rather solid, and the debt-to-GDP ratio (34%) is low by international comparison. We see no reason to anticipate a reduction in public spending in 2017 and count on further positive contributions.

Increasingly positive leading indicators for the manufacturing and industrial sectors

The latest leading indicators published for the industrial sector show that the manufacturing sector has regained a measure of cautious optimism. The manufacturing PMI has indeed reached its highest level since 2011 and has made a sharp recovery since its January 2015 tumble.

PMI - KOF



Sources: Bloomberg, BBGI Group SA

The manufacturing PMI indicator climbed to 60.9 in August, well above its low in May 2015 (47.3). Hesitations in Q2 have now made way to stronger confidence, as indicated by the satisfactory level of the KOF's leading index.

We maintain our optimistic forecast with regard to Swiss economic activity and anticipate a gradual improvement in economic conditions. We had also expected the monetary factor to provide a boost, and the appreciation of the euro, which we had been anticipating and is in fact intensifying, will contribute to these developments.

The appreciation of the euro has not yet significantly affected the SNB's actions

In spite of the decrease in economic uncertainty in the US and Europe, investor demand for Swiss francs remained relatively high during the first part of the year. Political uncertainty in the Eurozone has receded sharply. Geopolitical risks persist, but the improvement of the economic climate, which should reduce the demand for Swiss francs, will likely affect the euro's exchange rate even more.

The SNB's currency reserves stated in Swiss francs finally seem to be stabilising at around 700 billion. However, domestic banks' overnight deposits have been declining for three months already, while total overnight deposits have also been stabilising since 30 June.

We are not expecting the SNB to change its monetary policy this year. The negative rates will stay in place until the European economic cycle exhibits a clear reversal and a highly likely acceleration of growth in 2018.

Our 15 January 2015 post-choc forecast predicting an exchange rate of 1.20 against the euro is materialising

The rate spread is now much more favourable following the dollar-denominated rate increase, although it remains relatively unchanged against the euro at approximately 50 basis points. However, we believe it is now more likely to see rates normalise more quickly in the Eurozone than in Switzerland and thus benefit the European currency. Overall, our exchange rate forecasts are still current, although economic momentum in the US is at present not yet strong enough to push the dollar higher. In Europe, however, a change in perceptions regarding the situation in the Eurozone is clearly favouring a return of investors to the single currency.

Our exchange rate forecasts suggest further weakening of the euro to 1.20 against the franc and an uptick of the dollar to 1.05. These predictions also provide us the opportunity to note that we had presented and explained the arguments supporting our forecast at the time of the SNB's introduction of its negative interest rate policy.

In a particularly gloomy context in January 2015, we expressed confidence both in the strategy implemented by our national bank and in the economic and political recovery of the Eurozone, which would certainly provide the requisite conditions for the euro to strengthen.

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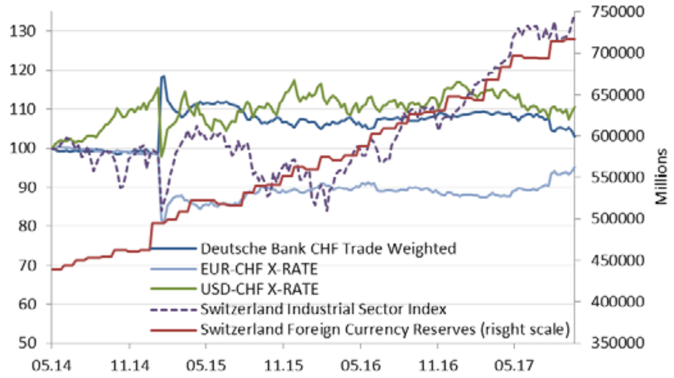
Exchange rates and SNB reserves



Sources: Bloomberg, BBGI Group SA

We remain convinced that the euro will return to a level of 1.20 against the franc, which is most certainly overvalued at its current level.

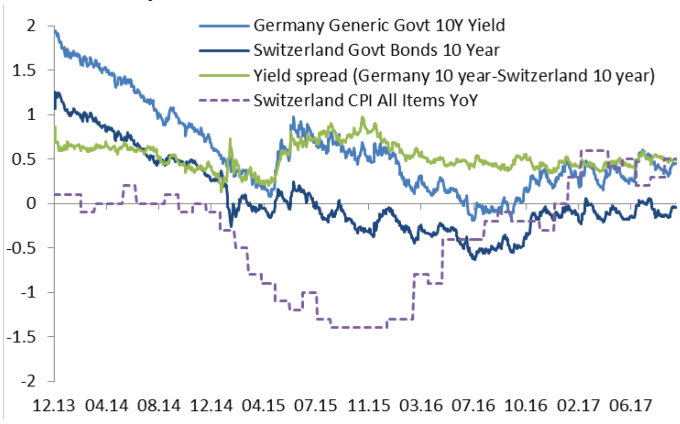
Impending rise of long-term interest rates and inflation in our country

Over the past several weeks, core inflation as well as other broader measures of inflation have pointed toward a return of price increases in our country.

The risks of deflation mentioned these past years as one of the most significant threats to our economy have dissipated as inflation climbed back up from its November 2015 lows (-1.4%) to +0.6% in February 2017. The latest figure published for August confirms the resilience of the CPI index above +0.5%. In addition, continued weakness of the franc will certainly have significant consequences with regard to imported inflation.

In this context, the normalisation of long-term interest rates in Switzerland remains dependent on the progress of normalisation on the international front and on developments in the euro/franc exchange rate. While the normalisation of long-term rates began last summer, as we had expected, its future course also depends on the flow of economic data. The disappointing performance of the US economy in Q1 and the uncertainties that arose in August caused a slight correction in short-term rates, which in our view constitute one of the last opportunities to reduce bond market risk, in particular in our country.

10-yr EUR & CHF interest rates, CPI



Sources: Bloomberg, BBGI Group SA

The appreciation of the euro is a significant factor increasing the risk of correction in our bond market.

The bond bubble is now likely to burst very soon.

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